Supreme Court, U.S.
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No. _____

IN THE

Supreme Court of the United States

October Term, 1996

DOCTORS HOSPITAL REAL ESTATE, LTD.,
DOCTORS HOSPITAL MANAGEMENT CO., INC.,
TAX MATTERS PARTNER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For Writ Of Certiorari
To The United States Court of Appeals for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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59 pp

Questions Presented

1. Did the United States Tax Court exceed its jurisdiction to determine partnership items in a proceeding brought pursuant to 26 U.S.C. § 6226 to the extent the Tax Court's Order and Decision (hereafter "Decision") held that "Doctors Hospital Real Estate, Ltd. fails to satisfy the noncorporate lessor requirements of I.R.C. sec. 46(e)(3) and thus fails to qualify for the investment tax credit for the taxable year 1984."? [Decision; Apx/11][1]

2. Were the annual rents received in excess of the portion of the rent equal to debt service merely a reimbursement of the partnership's required contribution to the operating expenses under the lease, as found by the Tax Court and sustained by the Fifth Circuit Court of Appeals, or should the courts have sustained the form of the transaction chosen by the parties according to this Court's holdings in *Frank Lyon Co. v. United States*, 435 U.S. 56 (1978)?

3. In sustaining the Tax Court's actions of repeatedly denying Petitioner's right to submit oral and documentary evidence regarding the intent of the parties and the negotiations leading to the final lease agreement and then disregarding the language and form of the agreement, holding the parties' intent to be something quite different. did the Fifth Circuit err in direct conflict with *Frank Lyon*.

4. Did the actions discussed in Question 3, and the Tax Court's further action of allowing a trial to proceed based on an original notice of final partnership administrative adjustment (hereafter "FPAA") and pleadings by the Internal Revenue Service that DHRE argued never articulated the proposed adjustments to partnership items and which were permitted to be amended on the day of trial allegedly to clarify the Government's position even though still not setting forth any specific adjustments to partnership items deprive the taxpayers of a right to a fair trial through a departure so far from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power

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[1] Unless otherwise indicated, all references to "[Decision; Apx/10]" shall be to the Order and Decision of the Tax Court in the underlying case which is reproduced verbatim beginning at Page 12 of the Appendix included herewith. "Apx/10" shall refer to the exact page of the Appendix at which the noted reference may be found; here, Page 10.

of supervision and violate the Petitioner's rights under the Fifth Amendment's due process clause?

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In addition, any spouse or partner who filed a joint return or any other indirect partner of *Doctors Hospital Real Estate, Ltd.*, but the identity of such indirect partners is unknown to Petitioner.

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Opinions Below

The Memorandum Findings of Fact and Opinion (hereafter "Opinion") of the Tax Court was filed on March 31, 1994, and is reported as *Doctors Hospital Real Estate, Ltd. v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2591 (1994). A verbatim reproduction of the Tax Court's and Opinion is contained in the Appendix attached hereto beginning at Page 1 of the Appendix.

The Order and Decision of the Tax Court (hereafter "Decision") was entered on February 3, 1995, and is unpublished. A verbatim reproduction of the Tax Court's Decision is contained in the Appendix attached hereto beginning at Page 12 of the Appendix.

The Fifth Circuit Court of Appeals issued a one-word unpublished opinion sustaining the Opinion and Decision from which the appeal was taken. A verbatim reproduction of the Fifth Circuit's opinion is included in the Appendix attached hereto beginning at Page 14 of the Appendix.

Jurisdiction of the United States Supreme Court

This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) and Rule 10(c) of the Supreme Court of the United States as a result of the decisions below being in direct conflict with the decision in *Frank Lyon Co. v. United States*, 435 U.S. 56 (1978). This court's jurisdiction is additionally invoked under 28 U.S.C. § 1254(1) because the questions presented are important questions of federal law as to the scope of the jurisdiction of the United States Tax Court in a proceeding brought under 26 U.S.C. § 6226, which question has not been, but should be, settled by this Court.

This Court's jurisdiction is also invoked under the due process clause of the Fifth Amendment to the United States Constitution as a result of:

(1) The Tax Court's and Fifth Circuit Court's rendering of a judgment outside the scope of their subject-matter jurisdiction;

(2) The Tax Court's failure to grant the Petitioner a fair trial as a consequence of allowing the Government to proceed based on inadequate pleadings and notices to Petitioner; and

(3) Denial of Petitioner's right to present relevant and important oral and documentary evidence.

The Fifth Circuit's opinion is also in direct conflict with other circuit courts of appeal that have followed this Court's precedent in *Frank Lyon* in interpreting lease agreements, characterizing transactions for income tax purposes, and reviewing a trial court's characterization of a transaction under a *de novo* standard of review.

Statutory Provisions and Regulations Involved

U.S. CONST. amend. V:

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

26 U.S.C. § 46(e)(3) (1984):

> (3) NONCORPORATE LESSORS.-- A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if-
>
> (A) the property subject to the lease has been manufactured or produced by the lessor, or
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts

with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an S corporation shall be treated as a person which is not a corporation. This paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E). For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168), the useful life shall be the present class life for such property (as defined in section 168(g)(2)).

163(d)(4):

(4) SPECIAL RULES.--

(A) Property subject to net lease.--For purposes of this subsection, property subject to a lease shall be treated as property held for investment, and not as property used in a trade or business, for a taxable year, if--

(i) for such taxable year the sum of the deductions of the lessor with respect to such property which are allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or

(ii) the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

26 U.S.C. § 6226(f):

(f) SCOPE OF JUDICIAL REVIEW.--A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership

administrative adjustment relates and the proper allocation of such items among the partners.

26 U.S.C. § 6231(a)(3):

> (3) PARTNERSHIP ITEM.--The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Treasury Regulation § 301.6231(a)(3)-1:

> § 301.6231(a)(3)-1. PARTNERSHIP ITEMS.--(a) *In general.* For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items.
>
> . . . .
>
> (i) Items of income, gain, loss, deduction, or credit of the partnership.
>
> . . . .
>
> (vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine--
>
> (A) The investment credit determined under section 46(a);
>
> . . . .
>
> (C) Amounts at risk in any activity to which section 465 applies;
>
> . . . .

(b) *Factors that affect the determination of partnership items.* The term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. Examples of these determinations are ... .

Statement of the Case

1. **Proceedings in the Tax Court**. The Internal Revenue Service (hereafter "I.R.S.") timely mailed to the tax matters partner (hereafter "TMP") of Doctors Hospital Real Estate, Ltd. (hereafter "DHRE" or "the Partnership") an FPAA determining adjustments to partnership items. The TMP timely filed a petition for readjustment under Internal Revenue Code[2] § 6226 with the Tax Court. Due to technical errors, the TMP filed a corrected amended petition. Respondent filed her answer. After discovery and negotiations, certain adjustments and readjustments to partnership items were conceded by both parties prior to trial. The Decision shows the partnership items addressed in the FPAA (i) as originally reported on DHRE's return, and (ii) as determined by the Tax Court. DHRE prevailed on approximately two thirds of the partnership item adjustments originally asserted in the FPAA.

At docket call for the trial, the Tax Court denied both of DHRE's motions to dismiss for lack of jurisdiction which asserted that the determination of whether or not the requirements of I.R.C. § 46(e)(3) were satisfied was not a partnership item and that determination of whether or not interest paid by the partnership should be classified as investment interest was not a partnership item.

At docket call, the Tax Court also granted the I.R.S.' motion to amend its answer asserting denial of the investment tax credit (hereafter "ITC") to DHRE as a partnership item adjustment. The FPAA had originally only asserted an adjustment to DHRE's basis in § 48(q) Property asserting that:

> (B) You have not established that any property in excess of that allowed meets the requirements for noncorporate lessors as provided by section 46 of the internal revenue code."[3]

FPAA Excerpt [Apx/17].

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[2] Unless otherwise stated, all references to "I.R.C.," "the Code," "Section" or "§" shall be to the stated section of the Internal Revenue Code, 26 U.S.C., as amended and effective for the years in issue.

[3] The § 48(q) reference made no sense at all and was meaningless since § 48(q) does not determine basis but merely provides for a reduction in basis to § 38 Property if ITC is claimed or, alternatively, an election to reduce the credit rather than basis; and § 46(e)(3) does not affect basis!

The I.R.S. had before trial conceded that DHRE's basis in § 38 Property was $4,005,416.00. The amendment at trial for the first time enlarged the proposed adjustments to partnership items to actually deny to the partners the ITC.

At trial, after the I.R.S.' amendment to its pleadings, the only remaining issues were whether certain interest payments were to be reclassified as investment interest and whether the ITC was allowable to DHRE. **The I.R.S. asserted no adjustments to any partnership items of DHRE's business expenses or rental income received in either the FPAA, the answer, or amended answer**.

After the Tax Court entered its Opinion, the I.R.S. filed unagreed Rule 155[4] computations. The Tax Court entered its decision incorporating the I.R.S.' computations and work papers as findings of fact. DHRE filed a motion to vacate because the Court had violated its own rules and not notified DHRE of the proposed computations nor granted DHRE time to object.[5] The decision was vacated, and after critical revisions requested by DHRE, agreed computations were accepted under Rule 155 and the final decision entered in accordance with the Tax Court's Opinion from which the appeal was taken to the Fifth Circuit.

2. **Proceedings on Appeal.** The Fifth Circuit received briefs on the appeal and heard oral argument. The Court, in a one-word unpublished opinion [Apx/13], sustained the Tax Court without any explanation. Subsequently, DHRE requested a published opinion and that the Court clearly articulate the basis on which the Court distinguished this case from *Frank Lyon Co. v. United States*, 435 U.S. 56 (1978), and clarify its determination of how the ITC holding of the Tax Court could be a determination of a partnership item. The Fifth Circuit denied DHRE's request. The Fifth Circuit had jurisdiction under I.R.C. §§ 6226(g) and 7482.

3. **Statement of the Facts**. The following facts were found by the Tax Court in its Opinion [Apx/1] and are not disputed.

In 1979, 45 practicing physicians in the Victoria, Texas, area recognized the need for a new hospital and organized Doctors Hospital of Victoria, Inc. (hereafter "DHV"), with the intent of developing and

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[4] Rule 155 of the Tax Court Rules of Practice and Procedure (hereafter "TCRP").

[5] TCRP Rule 155(b).

operating a hospital. The Doctors eventually realized they did not have the ability to develop and operate a hospital and needed a professional hospital management company. They chose Universal Health Services, Inc. (hereafter "UHS"), a Delaware corporation engaged in operating and owning acute-care hospitals.

Forty-three of the DHV shareholders plus two other persons formed DHRE, a limited partnership.. DHRE used the cash method of accounting and a calendar taxable year.

In 1982, DHV, DHRE, and UHS carried out a transaction memorialized in a Stock Purchase Agreement. In that transaction, UHS acquired DHV through a wholly owned Texas subsidiary. DHV exercised its option to purchase land on which to build the hospital. Then DHV as Lessor and DHRE as Lessee entered into two leases,-(1) a Ground Lease dated January 19, 1982, pursuant to which DHV leased certain land, and (2) a Hospital Lease, pursuant to which DHRE agreed to lease to DHV a hospital building DHRE would construct on the land. The Hospital Lease granted DHRE the option to lease to DHV any equipment DHV proposed to lease. **DHRE had no responsibility for any expenses under the Hospital Lease; all expenses were borne by DHV as Lessee.**

The hospital was completed in March, 1984, and placed in service on April 1, 1984. The total cost was $13,448,158.00, excluding construction-period interest in the amount of $987,618 and including the cost of the equipment. *Id.*

On March 30, 1984, DHV and DHRE entered into an agreement to execute a deed and bill of sale to clarify that DHRE owned the hospital building. **DHV agreed to lease the fixed equipment from DHRE**, and DHV transferred title to DHRE by a "Bill of Sale."[6] DHRE had not yet obtained permanent financing. UHS and its subsidiaries had invested over $14 million in construction financing and equipment purchases. DHRE memorialized its debt for construction costs and fixed equipment by giving UHS' subsidiary its note for $14 million while the parties continued to seek mutually agreeable third-party financing.

In 1984, UHS initiated renegotiation of the lease. On December 28, 1984, a renegotiated Hospital Lease was executed (the "Revised Lease"). Under both the Hospital Lease and the Revised Lease, the majority of the rent was "such amount as shall be required to maintain and service any indebtedness incurred in connection with the construction of the Hospital or in connection with any refinancing or

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[6] DHRE did not own any of the movable equipment in the hospital.

refunding of such indebtedness." **Under only the Revised Lease, DHV was liable for "additional rent" of $550,000 per year.**

The lease of the fixed equipment by DHRE to DHV was included in the Revised Lease. The Revised Lease did not articulate how the $550,000 was allocable between the equipment and the hospital. **Under the Revised Lease, DHRE's maximum contributions for expenses related to the fixed equipment total $550,000, an amount equal to the additional rent called for in the Revised Lease. Under the written terms of the Revised Lease, even if DHRE was not liable for the full $550,000, DHV would still be required to pay the full $550,000 additional rent.**

Argument

I. Jurisdiction of the Tax Court

The Tax Court is a court of limited jurisdiction, possessing only such power to adjudicate controversies as is expressly, statutorily conferred on it be Congress. I.R.C. § 7442. *Continental Equities, Inc. v. Commissioner*, 551 F.2d 74, 79 (5th Cir. 1977), aff'g. in part & rev'g. in part T. C. Memo 1974-189; *Transport Manufacturing & Equipment Co. v. Commissioner*, 434 F.2d 373, 381 (8th Cir. 1970); *Logan v. Commissioner*, 86 T.C. 1222, 1226 (1986). The Tax Court is without authority to enlarge upon that statutory grant of jurisdiction. *Phillips Petroleum Co. v. Commissioner*, 92 T.C. 885, 888 (1989). The Tax Court nevertheless has jurisdiction to determine whether it has jurisdiction. *Pyo v. Commissioner*, 83 T.C. 626, 632 (1984); *Kluger v. Commissioner*, 83 T.C. 309, 314 (1984). The jurisdictional issue is fundamental and must be addressed by the court when raised by a party or on the court's own motion. *Naftel v. Commissioner*, 85 T.C. 527, 530 (1985); *Young Est. v. Commissioner*, 81 T.C. 879, 880-881 (1983). If the Tax Court finds that it lacks jurisdiction to consider an issue, it may not decide this issue, even if all of the parties wish the issue to be decided by the Tax Court. *Naftel, supra.*; *Wheeler's Peachtree Pharmacy, Inc. v. Commissioner*, 35 T.C. 177, 179 (1960).

The source of the Tax Court's jurisdiction in this case is the authority granted in I.R.C. § 6226 to redetermine adjustments to partnership items asserted in an FPAA by the I.R.S. under I.R.C. § 6223.

The jurisdictional question brings to this Court for the first time an extremely important question of procedural tax law. The law enacted

in 1982 for determining adjustments to a partnership's tax return and the consequential tax liability of an individual partner bifurcates the procedural process. All determinations to adjustments to "partnership items" must be made at the partnership level. Subsequently, the determination of the individual partner's tax liability is made in a separate procedure at the partner level. The intent of Congress was to simplify partnership examination and partner deficiency procedures. In application, the statutes and regulations have been interpreted inconsistently in determining the definition of a "partnership item" subject to determination in a partnership level proceeding. **The lack of a clear definition of "partnership item" has made application of 26 U.S.C. §§ 6221-6233[7] absolutely chaotic. Even decisions coming out of the Tax Court are mutually inconsistent on this issue.**

The Opinion and Decision in the case at bar interpreted the definition of partnership item diametrically opposite to the Tax Court's interpretation in *Hambrose Leasing 1984-5 Limited Partnership v. Commissioner*, 99 T.C. 298 (1992), and *Hayes v. Commissioner*, 69 T.C.M. (CCH) 2323 (1995). Like the case at bar, *Hambrose* and *Hayes* were both dependent on the Tax Court's interpretation of Treas. Reg. § 301.6231(a)(3)-1. Adding to this chaos is that the case at bar is even inconsistent with the Fifth Circuit's own recent precedent in *Sealy Power, Ltd.. v. Commissioner*, 46 F.3d 382 (5th Cir. 1995). The decision in *Doctors Hospital Real Estate, Ltd. v. Commissioner of Internal Revenue*, 67 T.C.M. (CCH) 2591 (1994), is also in conflict with *Gemini Twin Fund III v. Commissioner*, 62 T.C.M. (CCH) 104, T.C. Memo 1991-315 (1991) aff'd. 9th Cir. (Unpublished opinion 10/21/93.)

In *Doctors Hospital*, "partnership item" was interpreted very broadly to include every fact determinable at the partnership level, whether or not required to be reflected on the partnership return. In *Sealy*, *Hambrose*, *Hayes*, and *Gemini*, a much narrower interpretation was adopted, restricting "partnership item" essentially to those facts and amounts required to be reflected on the partnership return and excluding partnership level facts or amounts not reflected on the return.

Although the courts have not always clearly articulated the problem, it boils down very simply to the meaning of the phrase (emphasized in bold below) "**required to be taken into account for the**

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[7] Partnership procedures codified at 26 U.S.C. §§6221-6233, as enacted by the Tax Equity and Fiscal Responsibility Act of 1982, Pub L. No. 97-248, 96 Stat. 324 (hereafter "TEFRA"), and as thereafter amended.

partnership's taxable year under any provision of subtitle A..." contained in the definition of "partnership item" in I.R.C. § 6231(a)(3).

Internal Revenue Code § 6231(a)(3) defines "partnership item" as follows:

> (3) PARTNERSHIP ITEM.--The term "partnership item" means, with respect to a partnership, any item **required to be taken into account for the partnership's taxable year under any provision of subtitle A** to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

[Emphasis added.]

As noted above, *Hambrose*, *Hayes*, and *Gemini*, restricted the definition to amounts or facts that are required to be **on a partnership return** or the schedules and forms attached to it. Other matters that involved partnership level inquiry but were not required to be reflected on or attached with the return were not partnership items. Petitioner will refer to this as the *Hambrose* position.

Under the *Hambrose* position, issues determinable from and requiring review of the partnership's books and records that must be resolved to determine a partner's tax liability are nevertheless not partnership items if they are not specifically reflected on the partnership return and must be reserved and determined in an individual partner level proceeding as affected items. This reservation included determining whether or not the **partnership transactions** were structured in such a manner that the partner could not deduct the losses reflected on the partnership return because he was not "at risk." *Hambrose, supra.*

There is considerable statutory, policy, and legislative history support for the *Hambrose* position. For example:

1. Section 6222(a) provides that "a partner shall, on the partner's return, treat a **partnership item** in a manner which is consistent with the treatment **of such partnership item on the partnership return.**" [This implies "partnership items" are items reflected **on the partnership return**, and that the term does not include partnership level determinations not reflected on the return.]

2. Similarly, § 6226(e) refers to the requisite deposit before a § 6226 case can be brought in a District Court or the Claims Court instead of the Tax Court (where no deposit is required) as:

> [T]he amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partners' return were made consistent with the treatment of partnership items **on the partnership return**, as adjusted by the final partnership administrative adjustment.

[Emphasis added.]

3. Congressional history shows that Congressional intent was to create partnership level procedures to determine "the tax treatment of items of partnership income, loss, deduction and credits...at the partnership level in a unified partnership proceeding rather than in separate proceedings with the partners."[8]

The position taken by the Tax Court in *Doctors Hospital* as sustained by the Fifth Circuit, is in direct conflict with the *Hambrose* position. We will refer to this as the *Doctors Hospital* position.

Under the *Doctors Hospital* position, the definition of a "partnership item" is expanded to include **any** amount or fact that requires a partnership level inquiry to ultimately determine a partner's tax liability. Specifically, the Fifth Circuit sustained the Tax Court finding that it had jurisdiction to determine that the partnership "fails to satisfy the noncorporate lessor requirements of I.R.C. Sec. 46(e)(3) and thus fails to qualify for the investment tax credit for the taxable year 1984" [Apx/11], despite the facts that (i) a partnership return does not report an ITC (it is a credit allowed to some but not all partners, not the partnership), and (ii) none of the requirements of I.R.C. § 46(e)(3) are specifically reflected **on the partnership return**. The key elements of the I.R.C. § 46(e)(3) test are:

> 1. The lessor (the partnership) must incur unreimbursed expenses equal to at least 15% of the equipment rental within a 12-month period beginning on the date the equipment is placed in service. This **cannot** be determined from the **partnership return**, as the partnership return (i) does not allocate deducted expenses between different classes of leased property (*e.g.* the building as opposed to qualifying equipment); (ii) does not reflect expenses based on the 12-month period of the test (the 12 months after equipment is placed in service, not the partnership's tax year); and (iii) does

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[8] *H. R.Conf. Rep. No. 97-760*, 97th Cong., 2d Sess. at 600 (1982-2) Cum. Bul. at 662.

not require special reporting of whether or not some of the rental income reported and sustained without adjustment might be legally treated as an expense reimbursement.

2. The term of the lease must be less than one half of the useful life of the rental equipment. Again, this **cannot** be determined from the **partnership return** because nowhere on the return is (i) the term of the lease **or** (ii) the useful life (as distinguished from ACRS class) of the equipment required to be disclosed.

3. Only a partner that is not a corporation is subject to the I.R.C. § 46(e)(3) test.

In short, the *Doctors Hospital* position is that any issue requiring a partnership level factual determination is a "partnership item," **whether or not it is reflected on a partnership return.**

The *Doctors Hospital* position certainly has some logical support. In many ways, it would be good **policy** to resolve **all** partnership level issues in the partnership level proceeding. In fact, the regulations adopted by the I.R.S.' implementing its authority to determine **which** of those items that are "required to be taken into account for the partnership's taxable year" shall be treated as partnership items may be easily interpreted to follow the *Doctors Hospital* position. They include in the definition of "partnership item":

> Items ... to the extent that a determination of such items can be made from determinations that the partnership is required to make ... for the purpose **of the partnership books and records or for purposes of furnishing information to a partner**.

Treas. Reg. § 301.6231(a)(3)-1(a)(iv). *[Emphasis added.]* Clearly, this regulation seems to define partnership items as **including** partnership level facts not necessarily reflected on the return, but nevertheless required to be taken into account **in the partnership's books and records.**

Both the *Hambrose* and the *Doctors Hospital* position are directly derived from the interpretation of Treas. Reg. § 301.6231(a)(1)(vi) which provides in pertinent part that the term "partnership item" includes:

> (vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and

operations necessary to enable the partnership or the partners to determine--

(A) The investment credit determined under section 46(a);

. . . .

(C) Amounts at risk in any activity to which section 465 applies...

The *Hambrose* court held that the reference to "other amounts determinable at the partnership level" had to be restricted to those matters directly reflected on the partnership return, and **excluded** matters not reflected on the partnership return. The Court held it did not have jurisdiction in a partnership level proceeding to determine whether the **partnership's** transactions with third parties were sufficient to protect a partner against loss under I.R.C. § 465(b)(4). *Id.*, 309. The Court held it would not be precluded from considering those partnership level questions in a partner level proceeding because they had not been "partnership items." *Id.* In a partner level proceeding for one of the *Hambrose* partners, the Court later did review and consider the partnership level transactions. *Hayes, supra.*

The *Doctors Hospital* court, with no analysis, concluded it could consider and determine all partnership level questions related to a partner's determination of his ITC, whether or not reflected on the partnership return. Opinion. Prior to trial, without explanation, the Court denied DHRE's motion to dismiss for lack of jurisdiction the issues of (i) whether DHRE qualified for the ITC under § 46(e)(3), and the recharacterization of interest expense as "investment interest."

Petitioner in this case urges the Supreme Court to decide this crucial question one way or the other with finality. At present, literally hundreds of cases are pending in the courts in proceedings where the court's jurisdiction and the validity of the judgments is uncertain.[9] Furthermore, it is presently impossible for the I.R.S. or a taxpayer to know in which proceeding an issue should be addressed. The result is going to be a chaos of invalid decisions and defaulted issues not raised in partnership level proceedings and later precluded in partner level proceedings unless a clear definition is established.

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[9] Including District Courts, the Court of Federal Claims, Bankruptcy Court, the Tax Court, and various appellate courts. Counsel for DHRE is personally involved in representing over 100 taxpayers in such cases unrelated to DHRE!

Partnerships are too common a vehicle for business ventures to allow this issue to remain unresolved. Petitioner urges this Court to adopt the *Hambrose* position, restricting "partnership items" to items specifically reflected on the partnership return for two simple reasons. The opinion in *Hambrose* concludes that the restricted definition is consistent with both Congressional intent and the statutory language in TEFRA. The *Hambrose* position creates a clear, bright line between what is subject to a partnership level proceeding and what is reserved to the partner level proceedings. The partnership level proceeding would be restricted to an examination of and adjustments to the return filed by the partnership.

Petitioner recognizes, and even agrees with the I.R.S. that the better policy, had Congress so chosen, would be to include all partnership level determinations in the term "partnership item," as the regulations seem to contemplate. That, too, would create a clear and bright line. Everything determinable at the partnership level (unlike the *Hambrose* and *Hayes* cases) would be resolved in a TEFRA partnership item case, and a further review of partnership level books, records, and transactions would be barred in a subsequent partner level proceeding! This would be entirely consistent with the general intent of TEFRA.

What is most important is that this Court agree to hear this case and render a clear definition creating a bright line test one way or the other providing guidance in future and pending cases.[10]

The few cases addressing the bifurcated nature of TEFRA tax procedural law articulate the basic concepts. The seminal case is *Maxwell v. Commissioner*, 87 T.C. 783 (1986), which explained the dichotomy as being between the partner level procedures applicable to the determination of tax deficiencies and the partnership level procedures applicable to the adjustment of partnership items.

The Fifth Circuit itself also recently explained:

> In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act (TEFRA) to improve the auditing and adjustments of income tax items attributable to partnerships. TEFRA provides auditing and litigation procedures which have

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[10] If this Court adopts the *Hambrose* analysis and reverses the Tax Court on the jurisdictional question, the Government will not be jeopardized, for it will still have one year after the case becomes final to issue notices of deficiency at the partner level.

> shifted the Service's focus from the individual partner to the partnership as a whole, thus creating an important distinction between partnership and nonpartnership items. The law creates partnership-level procedures to deal with partnership items, that is, to determine "the tax treatment of items of partnership income, loss, deductions, and credits ... at the partnership level in a unified partnership proceeding rather than in separate proceedings with the partners." H.R.Conf.Rep. No. 97-760, 97th Cong., 2d Sess. at 600 (1982-2) Cum.Bull. at 662.

Alexander v. United States, 44 F.3d 328, 330 (5th Cir. 1995).

The *Alexander* definition conflicts with *Doctors Hospital*. In *Alexander*, the Fifth Circuit held that "the critical inquiry [regarding the Court's jurisdiction] is whether the refund action here is attributable to partnership or nonpartnership items." *Id.*, 331.

The statute divides disputes arising from "partnership items" from disputes arising from other nonpartnership items (including the subset of nonpartnership items called affected items). If the tax treatment of a "partnership item" is at issue, the statute requires the matter to be resolved at the partnership level. I.R.C. § 6221. *Roberts v. Commissioner*, 94 T.C. 853, 859-860 (1990).

In *N.C.F. Energy Partners v. Commissioner*, 89 T.C. 741 (1987), the Tax Court addressed the subset of nonpartnership items called "affected items" which include "any item to the extent such item is affected by a partnership item." I.R.C. § 6231(a)(5); Temp. Treas. Reg. § 301.6231(a)(5)-1T(a), Temporary Proced. & Admin. Regs., 52 Fed. Reg. 6790 (Mar. 5, 1987). The Court held that once the partnership level proceeding is completed, the I.R.S. may issue a notice of deficiency to the partner determining additional deficiencies attributable to affected items, but held that it lacked "jurisdiction [in a partnership level proceeding] over the issues relating to affected items ...." *N.C.F.* at 743-746. The ITC determination in *Doctors Hospital* should have been an "affected item."

This jurisdictional issue arose in *Doctors Hospital* because the I.R.S., in its amended answer, raised the allegation that:

> Doctors Hospital Real Estate, Ltd., is not entitled to the investment tax credit which the Tax Court claimed on its Form 1065, U.S. Partnership Return of Income, for the taxable year 1984 because the partnership fails to satisfy the requirements

imposed on noncorporate lessors by I.R.C. Section 46(e)(3)(A) and (B).

The Tax Court exceeded its jurisdiction when it held in the Decision, in a footnote, that:

> Doctors Hospital Real Estate, Ltd., fails to satisfy the noncorporate lessor requirements of I.R.C. Sec. 46(e)(3) and thus fails to qualify for investment tax credit for the taxable year 1984.

As discussed above, the Tax Court did not have jurisdiction to determine adjustments to nonpartnership items, including affected items, in a partnership level proceeding. *Roberts, at 853; Hambrose.*

Roberts and *Hambrose* both hold that the determination of whether or not a partner is "at risk" with regard to a partnership activity is an affected item over which the Tax Court has no jurisdiction in an I.R.C. § 6226 partnership level proceeding. In so holding, they, like *Doctors Hospital,* interpreted Treas. Reg. § 301.6231(a)(3)-1(a)(vi), which addresses **both the "at risk" (*Hambrose)* and ITC (*Doctors Hospital*)** issues as follows:

> (vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine--
>
> **(A) The investment credit determined under section 46(a);**
>
> . . . .
>
> **(C) Amounts at risk in any activity to which section 465 applies;**

[*Emphasis added.*] The *Hambrose* interpretation was diametrically opposed the *Doctors Hospital* interpretation **of this same regulation!**

It is arguable, however, that the *Roberts* opinion is actually consistent with the *Doctors Hospital* position because it did not look at partnership level transactions but looked only at partner level transactions. The *Hambrose* Court then, however, went far beyond the *Roberts* holding, possibly even in conflict with *Roberts*. Following *Roberts*, the *Hambrose* court held the amount at risk under § 465 **was not an item required to be determined by the partnership and, therefore, is not a "partnership item."** *Id.*, at 862, *emphasis added.*

The *Roberts* court held only that it had jurisdiction to the extent the notice of deficiency made the "at risk" disallowance at the partner level based upon third-party stop-loss agreements **with partners** outside the partnership.

Although citing *Roberts* and other Tax Court cases, the Tax Court did not similarly limit its holding in *Hambrose*. The Court went further and concluded that an item is not a "partnership item" unless required to be taken into account for the taxable year of the partnership, even though the regulations may **seem** broad enough to permit virtually any determination of an item in a partnership level proceeding so long as it is related, even remotely, to the partnership. The Court concluded that in the TEFRA proceeding, it had jurisdiction **only** "over the **partnership item components** which affect that determination at the partner level, namely, the recourse or nonrecourse nature of the partnerships' notes ...." *Id.* at 311, 312, *emphasis added.* It reserved to the **partner level proceeding** the determinations of whether facts not directly reflected on the partnership return would be considered protection against loss sufficient to preclude any partner from being at risk. **This went far beyond the *Roberts* holding that review of partner level transactions that could have that result must be deferred to a partner level proceeding.**

The *Hambrose* position would be equivalent to determining in *Doctors Hospital* only the partnership's **basis** in § 38 Property and the amounts of rent received and expenses paid as deducted on the return (not questioned in *Doctors Hospital*), but excluding issues not on the partnership return (such as useful life of equipment, allocation of expenses among assets, timing of expenses, and lease terms).

In DHRE, **no** adjustments to **any** of the partnership items that might constitute the "partnership item components" (within the *Hambrose* meaning) of a partner's ITC were **ever** asserted in the FPAA or any answer or amended answer filed in the case. The **only** assertion was that DHRE "fails to satisfy the noncorporate lessor requirements of I.R.C. § 46(e)(3) and thus fails to qualify for the investment tax credit for the taxable year 1984." For the same reasons the *Hambrose* court held that amounts at risk are not partnership items, neither is ITC. It is **not** a credit allowed **to the partnership**. It is **not** required to be taken into account by the partnership. It can **only** be determined **after** other facts are determined for the individual partner. Under the *Hambrose* position, ITC is an affected item which can be dealt with only in a partner level deficiency proceeding and not in a partnership

level proceeding and, in such a subsequent partner level proceeding, none of the partnership item components may be reconsidered.

The existing schizophrenia in the decisions is also reflected in the fact that the *N.C.F.* case is also diametrically opposite to the Tax Court's opinion in the case at bar because the determination for income tax purposes of whether the partner is a corporation, an individual, or some other entity is one **critical to the determination of whether or not the noncorporate lessor limits on ITC apply to the partner**, and in *N.C.F.*, the Court held that the I.R.C. § 6659 penalty could not be a partnership item because section 6659 also may require findings of fact peculiar to the taxpayer, **"including that the taxpayer is an individual, a closely held corporation, or a personal service corporation ... ."** *N.C.F., supra.*, at 746.

This continuing whipsawing of the definition of partnership item from case to case must be stopped, and that will occur only if this Court takes this opportunity to enter a definitive decision creating a clear, bright line definition of partnership item resolving many cases now pending and giving guidance for future proceedings.

II. Conflict With *Frank Lyon* and various Circuit Court Opinions.

The Fifth Circuit sustained the Tax Court's holding that the annual additional rent paid to DHRE of $550,000 was actually reimbursement of the operating expenses paid by DHRE, thereby (i) failing to meet the I.R.C. § 46(e)(3) requirement for a partner to claim ITC that noncorporate lessors must incur **unreimbursed** expenses in the first 12 months of the lease greater than 15% of rental income to qualify for the ITC, and (ii) failing to meet the I.R.C. § 163(d)(4) requirement for 1985 and 1986 calendar year that the lessor must incur annually **unreimbursed** expenses greater than 15% of rental income (from both the hospital and the equipment) to avoid classification of interest paid on the debt as "investment interest" subject to serious restrictions on the amount each partner could deduct.

The characterization of the rent payments as a reimbursement of expenses was therefore a crucial determination as to both the 1984 ITC disallowance and the interest reclassification in 1985 and 1986.[11]

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[11] The partnership conceded the 1984 interest reclassification because expenses were not paid until 1985 and I.R.C. § 164(d)(3), the expense test is applied on a tax

(continued...)

Before reaching this conclusion of law, the Tax Court entered, *inter alia*, the following findings of fact:

1. "In 1984, UHS realized that the form of the hospital lease failed to meet certain standards of the Financial Accounting Standards Board and UHS initiated renegotiation of the lease." Opinion [Apx/5]

2. Under the Revised Lease, DHV was liable for "additional rent" in the amount of $550,000. [Apx/6]

3. The lease of the fixed equipment by DHRE was included in the Revised Lease. *Id.*

4. Under the Revised Lease, DHRE's **maximum contributions** for expenses **related to the fixed equipment** total $550,000, the amount of the additional rent called for in the Revised Lease. *Id.*

5. Under the Revised Lease, even if DHRE was not liable for the full $550,000, DHV would still be required to pay the $550,000 additional rent. *Id.*

6. DHRE always intended to have the equipment it leased to DHV qualify for the investment credit, and DHRE knew it would have to contribute to the maintenance of the equipment. *Id.*

The Revised Lease included **both** (i) the renegotiated terms of the original Hospital Lease initiated by the lessee, and (ii) the new terms related to the lease of the fixed equipment. The Revised Lease called for total rent equal to (i) the debt service, plus (ii) $550,000. It also provided that the **maximum** expense contribution by DHRE would be $550,000.

The Tax Court ignored the lease terms to reach its legal conclusions, and simply ignored the controlling precedent of this Court in *Frank Lyon* which set the definitive test for when the form of a transaction entered into by the parties should be respected by the I.R.S. and the courts. That test was enunciated by this Court, and has often been cited as the accepted rule, as follows:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encourage by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way,

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[11] (. . . c o n t i n u e d) year basis.

> so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.

Frank Lyon, 583-84.

In *Doctors Hospital*, the parties included numerous physicians practicing in the hospital, a publicly traded national corporation and its subsidiaries, and a major bank. The Tax Court recognized the legitimacy of the parties and the legitimate business purpose and need for the hospital. It also recognized the business purpose behind the hospital lease renegotiation and that expense contributions were always intended by DHRE if it leased equipment to the hospital.[12] The Opinion even recognizes that DHRE knew it had to find an additional source of revenues in the lease renegotiations to cover its expense contributions. Despite all of this, the Tax Court treated the characterization of the $550,000 annual payment as rent was a sham, disregarded the intent of the parties and the express terms of the lease, and held the $550,000 annual payment to be a reimbursement of the expenses paid by DHRE.

Numerous circuit courts of appeal have interpreted *Frank Lyon* as creating a two-part requirement for a finding that a transaction is a sham and therefore disregarding the form adopted by the parties. *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989); *Hunt v. Commissioner*, 938 F.2d 466 (4th Cir. 1991); *Skeen v. Commissioner*, 864 F.2d 93, 89 (9th Cir. 1989); *Gilman v. Commissioner*, 933 F.2d 143 (2nd Cir. 1991), cert. denied (1992); *Lukens v. Commissioner*, 945 F.2d 92, 99 (5th Cir. 1991). **There must be no economic substance and no business purpose.** There is no support or finding in this case for either proposition, let alone both. Moreover, treatment of the rent payment as a sham was inconsistent with the fact that neither the I.R.S. nor the Tax Court asserted that (of the partnership items on the return), "net rental income" should be reduced by the $550,000 received as annual additional rent or that the receipts should be reclassified as "Other Income" in the form of an expense reimbursement. Even the Opinion

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[12] DHRE had an option to lease to DHV any equipment DHV elected to lease rather than own, but until the 1984 hospital lease renegotiations, it had not been determined if DHV would choose to own the equipment or lease it, and whether or not DHRE would execute its option to be the lessor if DHV elected to lease. Terms for the possible equipment lease were not included in the original hospital lease, leaving them to be renegotiated if the parties decided to proceed with a lease.

and the final Decision include the $550,000 per year as **rental income**.[13]

As will be discussed in greater detail in Part III of this Argument, the *Doctors Hospital* case is also in direct conflict with *Frank Lyon* because of the Tax Court's repeated refusal to hear oral testimony and admit documentary evidence (stipulated by the parties as genuine business records of DHRE) of the content of the lease negotiations and multiple drafts exchanged.

In *Frank Lyon*, this Court made clear that the content of the lease negotiations was an important factual element of the case. The disregard by the Tax Court of the content, duration, and tenor of the lease negotiations in exchange for concessions desired by UHS and DHV from DHRE substantially **after** the commitment to contribute to expenses was memorialized in the lease drafts, is a rejection of the significance given to those factors by this Court in *Frank Lyon*.

Additionally, in *Frank Lyon*, this Court found significant that the tax consequences resulting from the form of the transaction did not arise solely because of the form of the transaction creating the benefits, but would have been available had the transaction taken other forms as well. *Frank Lyon*, 580, 582 f/n 18. In DHRE, the undisputed facts show that the doctors (DHRE partners) initially began the hospital's development as an integral part of their medical practices but came to recognize that they did not have the administrative expertise to run the hospital. Had they built the hospital as originally contemplated and simply hired a management company to operate it, nobody would dispute their right to the ITC or assert that the interest paid was "investment interest." When the **entirety** of the transaction is considered, the development of this hospital is **exactly** the type of development the ITC was intended to encourage.

Similarly, had the equipment lease been separately drafted instead of unartfully included in the revised hospital lease, there is little or no doubt that there would have been no challenge to the ITC if the

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[13] Under the TEFRA procedures and *Hambrose*, this would seem to be the proper adjustment to "partnership items" to be asserted if this was the issue the I.R.S. was pursuing. However, it did not do so. In the FPAA, it asserted as a partnership item adjustment a reduction in the § 38 basis of property that it later substantially conceded. In its amendment to its Answer, it ambiguously asserted only that ITC should be disallowed based on the application of I.R.C. § 46(e)(3). It never, at any time, sought to disallow or reclassify any part of the "rental income" as "other income."

$550,000 was the additional **hospital** rent traded for independent concessions in the Revised Lease by DHRE, and the **equipment related** expense contributions were separately stated in the separate equipment lease.

The bottom line is that the I.R.S., the Tax Court, and the Fifth Circuit have exalted **form over substance** by refusing to consider the **overall** transaction and then asserted **"substance over form"** to reach an interpretation of the lease agreement in contradiction to the terms of the documents, the testimony, and the proffered but refused documentary evidence solely because DHRE was astute enough to negotiate for and trade for enough additional annual rent to ensure it could pay its maximum required expense contributions! This is in no way even remotely consistent with this Court's holdings in *Frank Lyon*.

III. The taxpayers were deprived of a fair trial.

Two important policy concerns conflict in tax cases. One of the most important rights of an American is the right to a fair and impartial trial in a dispute with his government. However, because of the importance of an efficient administration of our federal income tax laws, the tables in such a dispute are tilted substantially in favor of the government. In a Tax Court proceeding, the I.R.S.' position (established by a revenue agent and not reviewed by an I.R.S. attorney) that was taken in the original FPAA is given the presumption of correctness and the burden of proof is placed on the taxpayers to overcome the adjustments proposed. DHRE does not dispute that this is as it should and must be for our tax system to work efficiently. **However, for the taxpayers to receive fair treatment and due process with those beginning advantages given to the government, the taxpayers must be given every reasonable chance to fully present their case and overcome the presumption and burden of proof.** If the taxpayer is not given that opportunity, then there is a serious risk of the tribunal's becoming nothing more than a star chamber, enforcing the decrees of low-level governmental employees who issue the original FPAAs.

The fact that the presumption of correctness is often in fact a misplaced presumption is evidenced by the fact that in this case, most of the asserted adjustments in the FPAA were either conceded by the I.R.S. prior to trial or defeated in the Opinion.

In *Doctors Hospital*, the FPAA asserted an adjustment to DHRE's basis in its equipment. It did not purport to disallow ITC. The basis

issue was mostly conceded by the I.R.S. prior to trial. **At trial**, the I.R.S. filed an amendment to its answer asserting for the first time in its pleadings that it was denying the ITC to the partnership. The proposed disallowance of the ITC was a new matter, requiring radically different preparation of factual evidence (as opposed to what was necessary to prove the cost basis of the equipment)!

When the Court asked the I.R.S.' attorney why a copy of the amendment was not previously given to DHRE, the Government's response was:

> **Ms. McClure:** No, Your Honor. I guess just that workload of getting ready for the trial, it slipped my mind.
>
> I thought it was thoroughly explained as to what it said, that it was simply to clarify that the investment tax credit is not allowable to the partnership; it raises no new issues; it entails no new facts. It is simply a clarification of what the adjustment with respect to the investment tax credit was in the Notice of Final Partnership Administrative Adjustments.

Respondent's counsel knowingly, or with inexcusable neglect, represented that (1) the original FPAA disallowed the ITC, and (2) DHRE "claimed [the ITC] on its Form 1065 ... ." The FPAA only asserted an adjustment to DHRE's **basis** in § 38 Property and **nowhere** asserted an adjustment to DHRE's allegedly "claimed" tax credit. **Nowhere** on DHRE's Form 1065 for 1984 is there any ITC claimed. There is not even a place on the form to report ITC!

The Tax Court should have denied leave to amend. TCRP Rule 41(a). Amendments will not be allowed if surprise, disadvantage, or prejudice results to the opposing party. *Stromstead v. Commissioner*, 53 T.C. 330, 340 n.5 (1969). Leave to amend an I.R.S. Answer at trial should be denied when the Petitioner is surprised, disadvantaged, or prejudiced. *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708, 733-36 (1981).

The FPAA, the Petition, and the I.R.S.' Answer all make clear why the issue was reasonably perceived by DHRE to be an adjustment to the basis in § 38 Property **as stated in the FPAA**. Nevertheless, the I.R.S. waited until the first day of trial to amend its answer to assert that it was adjusting ITC. This resulted in extreme prejudice to DHRE. DHRE was absolutely certain that the I.R.S.' adjustments to basis, except to the extent of the small adjustment acknowledged, was clearly erroneous. The concession by the I.R.S. that basis was $4,005,416 instead of the

$65,000 it had asserted make clear that DHRE was proper in believing it was not faced with any serious adjustment to basis.

The amendment raised a **new** issue not previously addressed in the FPAA or any of the pleadings, requiring significantly different elements of proof than the only other remaining issue for trial, which was the recharacterization of interest as investment interest. If the I.R.S. intended to disallow ITC, it had no excuse for delaying the filing of its amendment. The question of prejudice to DHRE is obvious. DHRE had no reason to fear any adjustment to basis in excess of that to which it had agreed; therefore, it had no reason to prepare for trial on the noncorporate lessor issues (the stated reason for the original basis adjustment).

The 15% expense test applicable under the ITC I.R.C. § 46(e)(3) rule applies to expenses incurred in the first 12 months after the property is placed in service. I.R.C. § 46(e)(3) By contrast, the 15% expense test relative to the determination of investment interest applies **on a calendar year basis**. I.R.C. § 163(d)(4) Also, the I.R.C. § 46(e)(3) test relates only to the rent and expenses related to the equipment. The I.R.C. § 163(d)(4) test relates to the total rent and expenses related to **both** the hospital and the equipment. The factual elements necessary to sustain each test are quite different, and the preparation for trial relative to those two highly **different** tests are radically different. The second portion of the noncorporate lessor rule (the useful life of the equipment) is **not** even an issue in the determination of whether or not interest is investment interest. As a consequence, DHRE was forced to attempt to prove an issue which was not an element of **any** matter which it had reasonable notice would be tried.[14]

The I.R.S. never proposed specific adjustments to any of the partnership item components of ITC. In a partnership proceeding, individual elements that must ultimately taken into account by the partners in determining their ITC that are reflected on the partnership return and are determinable at the partnership level constitute **partnership item components** of the ITC determination. *Hambrose*,

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14 The categorization of the equipment as § 38 Property had been an issue until the I.R.S. conceded that the basis adjustment should only be to the $4,005,416 as agreed and determined by the Court. DHRE had anticipated and engaged an expert witness to evaluate the equipment for that purpose, not originally to determine useful life.

at 308. Treasury Reg. § 301.6231(a)(3)-1(a)(1)(vi). No such proposed adjustments were **ever** made in the FPAA or I.R.S. pleadings!

The Government's motion to amend was granted over DHRE's objection. Notwithstanding its own rules regarding the burden of proof, the Tax Court held, in its Opinion, that "[t]he notice of deficiency [sic] benefits from a presumption of correctness, and petitioner bears the burden of proving it erroneous."[15] [Apx/17]

The Tax Court rules compensate for this presumption of correctness and placement of the burden of proof by reversing that burden as to any new issues raised by the government in its Answer to the taxpayers' Tax Court petition. Nevertheless, the Court simply disregarded the change in burden of proof relative to the ITC issue resulting from its being raised in an amendment made the first day of trial. The resulting prejudice to DHRE was enormous considering income and expenses on the return were not challenged, but factors **not on the return** had to be proven by the taxpayers, including the proper characterization of the rent payments, the lease term, the useful life of the equipment, and the timing of the expenses.

The prejudice to the taxpayers did not stop with the late amendment and erroneous placement of the burden of proof; it went on throughout the trial.

In *Frank Lyon* , this Court found the lease negotiations an important factor in determining the characterization of the transaction for tax purposes. At trial, DHRE repeatedly tried to offer documentary and oral evidence the lease negotiations.

Copies of the drafts of the leases prepared during negotiations were part of a stipulation filed with the Tax Court and made a part of the record. When DHRE asked Dr. Sage, president of the TMP, to review those lease drafts and testify about the course of negotiations and intent of the parties, the Court sustained the IRS' relevance objection. The following exchange occurred:

> **Ms. McClure:** In response, Your Honor, I think the final document is what is relevant, and **it speaks for itself** about what the additional rent was and that it equaled the additional expense contributions. What the drafts may have been did not

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[15] In *Doctors Hospital*, there is no "notice of deficiency" but an FPAA, the content of which is radically different. A notice of deficiency proposes an actual tax liability to an individual. An FPAA sets forth specific proposed adjustments to the return of income (not tax) filed by a partnership.

end up in the final document. I don't think that they are relevant.

The Court: Sustained.

[Tr:153-154, *Emphasis added.*][16]

It is the established policy of the Tax Court to liberally admit extrinsic evidence in order to base their decisions on the substance of documents rather than form. *Estate of Craft v. Commissioner*, 68 T.C. 249, aff'd. per curiam, 608 F.2d 240 (5th Cir. 1979)(aff'd. on other grounds). In *Scofield v. Greer*, 185 F.2d 551, 552 (5th Cir. 1950), the Fifth Circuit interpreted a written agreement based upon extrinsic evidence. In the past, the Tax Court has admitted extrinsic evidence in construing the terms of leases with regard to I.R.C. § 46. *Carlson v. Commissioner*, 79 T.C. 215, 218 (1982). In construing I.R.C. § 46 with regard to ITC, the Tax Court must "consider all of the surrounding circumstances in order to determine the **intent of the parties** as revealed in their actions and statements in the overall economic realities of a situation." *Freesen v. Commissioner, 84 T.C. 920, 943 (1985).* Most importantly, negotiations are an element the United States Supreme Court considered **not only relevant but important** in determining the "substance" of a transaction where the IRS asserted substance different from the "form" used by the partner. *Frank Lyon.* The Tax Court, in *Doctors Hospital*, abandoned all of that precedent and moved to a new position of accepting the I.R.S.' recharacterization and denying the taxpayer the opportunity to corroborate the *bona fides* of the terms of the documents!

In DHRE, there are several reasons why the lease drafts and negotiations are critical evidence:

1. The I.R.S. asserted the additional rent in the Revised Lease ¶20.06 was merely a reimbursement of DHRE's cumulative expenses paid under ¶¶6.01, 11.01, 15.01, and 15.02, which assertion is normally accorded the presumption of correctness and DHRE would have the burden of proof. [17]

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[16] References to [Tr:__] shall be to the referenced page(s) of the transcript of the trial before the Tax Court held in Houston, Texas, on October 18, 1993. The transcript is located at Document No. 2 of the Record on Appeal.

[17] But here, where the I.R.S. obliquely raised the issue for the first time at trial (if this Court finds it has been properly raised at all), the burden of proof should have been shifted to the I.R.S. TCRP Rule 142.

2. The I.R.S.' assertion was inconsistent with the language of the lease terms.
3. The I.R.S.' assertion addressed the intent of the parties.
4. The lease drafts corroborate Dr. Sage's and Dr. Jackson's testimony about the extended negotiations, the trade-offs made, the intent behind the lease provisions, and the fact that the expense contributions were inserted in early lease drafts long before the additional rent provision was obtained in exchange for substantial concessions by DHRE unrelated to the expense contribution requirements.
5. The Tax Court disregarded this testimony and construed the lease in direct contravention of its literal terms after denying admission of corroborating evidence.

Even though the I.R.S. is at liberty to challenge the language of a contract to establish the true substance of the transactions (as it must be in order to maintain the integrity of our tax laws). Our Tax Court will indeed become a "star-chamber" meting out marsupial jurisprudence if its rules permit the I.R.S. to assert "substance" to a transaction inconsistent with the terms of the documents but refuse to admit extrinsic evidence of the intent of the parties or the course and content of the negotiations on the basis of relevance asserting that "[t]he document speaks for itself."

The Tax Court's own precedent in *Elrod v. Commissioner* is that extrinsic evidence offered to overcome the I.R.S.' presumption of correctness and "not to vary or contradict the terms of the contract but rather to corroborate and confirm his [Petitioner's] position" is admissible over the I.R.S.' objection. *Elrod v. Commissioner*, 87 T.C. 1046, 1066 (1986).

When Dr. Anderson was asked about the relationship of his medical practice to the hospital and his utilization of hospital equipment, the I.R.S. objected on the basis of relevance. DHRE explained the purpose was to establish that some partners had § 162 expenses related to the equipment. The Tax Court sustained the objection and struck the limited testimony. The same occurred when Dr. Shook and Dr. Donahoe were called as witnesses.

When Dr. Anderson was questioned, as one of the officers of the TMP, about his knowledge regarding the final lease and its application to equipment, the I.R.S. objected, stating, "Objection. The document speaks for itself." The Court responded, "Sustained." [Tr:31, *emphasis added.*]

When Dr. Jackson, one of the TMP's officers, the original organizer of the doctors, and a major principle in the negotiations, was asked his understanding of ¶20.06 of the Revised Lease (the additional rent payment the Tax Court ultimately held to be a reimbursement of DHRE's expense payments), the Tax Court injected before Dr. Jackson could answer: **The Court: The paragraph speaks for itself.** [Tr:99-100; *emphasis added.*]

When Dr. Sage was asked about the lease negotiations, the Tax Court refused to permit the testimony: **The Court:** Excuse me. I don't think it is important to know. Let's move on. [Tr:162]

When testimony was sought from Dr. Sage, the principal negotiator for DHRE and principal officer of the TMP, regarding his understanding of the risk to DHRE if the lessee defaulted, the Tax Court again prohibited the testimony. [Tr:170-171]

When Dr. Sage was asked if it was his understanding that the lease's expense contribution clauses called for a fixed amount to be paid by DHRE or only called for contributions up to a specific cap, the Court again prohibited the testimony on the I.R.S.' objection and statement that "the document speaks for itself." [Tr:171-172] **Although the Court refused to hear this testimony and sustained the objection on the basis that "the document speaks for itself," in the Opinion, the Court reversed itself and held in direct contradiction to the express terms in the lease that "we do not credit petitioner's argument that DHRE's payment to DHV was merely capped at $550,000, and might have been less."** Opinion [Apx/8]

This continuing refusal to hear extrinsic evidence in corroboration of the express terms of the lease, in the face of the presumption of correctness given to the I.R.S. and the burden of proof placed on the taxpayers is a clear denial of a fair trial.

The Tax Court directed that it did not want cumulative testimony and implied that testimony not refuted by the I.R.S. would be accepted:

> **The Court:** Mr. Redding, I don't want to get into cumulative testimony here. If we have had all of this, I don't -- it is not refuted by the Respondent. There is no need to make a cumulative --

[Tr.161.]

When corroborating testimony was solicited from Richard Wright, an officer of the lessee, the Tax Court again advised DHRE:

The Court: This is repetitive testimony. I have heard this several times this morning.

Mr. Redding: I am sorry, Your Honor. I just wanted to confirm the understandings on the other side as well as on my clients' side.

The Court: I appreciate it. As long as it is not refuted by the Government, I don't need to hear it again.

[Tr:195]

The Tax Court continually refused to hear corroborating testimony, as emphasized in the following statement by Judge Laro:

The Court: If it is repetitive and cumulative, I am directing you not to ask those type questions.

[Tr:203]

The Tax Court frequently holds a taxpayer's testimony to be self-serving and gives it little weight. How can the taxpayer receive a fair trial if the Court refuses to hear corroborating testimony and accept corroborating documents? It cannot. This cannot be due process.

In summary, the Tax Court, through sustained relevancy objections and its own refusal to hear corroborating testimony severely prejudiced DHRE's ability to try its case and obtain a fair trial. The Tax Court should be reversed. On the record in this case, on a *de novo* review, the annual additional rent should be sustained as just that: rent, and not an expense reimbursement. The Tax Court should be held to its own repeated rulings at trial that "the document speaks for itself." The language of the lease clearly sustains the taxpayer's position.

CONCLUSION

Consideration of this case by the Supreme Court is extremely important. The question of the Tax Court's jurisdiction in a § 6226 case is a current problem in cases involving literally hundreds of taxpayers unrelated to this case. It is among the most fundamental, important, and inconsistently interpreted questions in the administration of partnership procedural tax law. We beg this Court to hear and resolve this question.

The Tax Court's Opinion in *Doctors Hospital* essentially permits the I.R.S. to recharacterize any transaction in the light producing the

greatest tax revenues regardless of the intent or business purpose of the parties. This surely is not the intent of Congress and is in direct conflict with *Frank Lyon*. DHRE asks this Court to review this case and breathe new life into the *Frank Lyon* rules for determining when the form of the taxpayers' transaction should be honored.

Of greatest importance is the need for citizens, as taxpayers, to be assured a fair trial and due process when a conflict arises with the Internal Revenue Service. The present view by many taxpayers and members of the bar of the Tax Court's treatment of taxpayers is rapidly eroding. This has even been reflected in circuit courts of appeals' published opinions in recent years. [18] This case presents an important opportunity for the Supreme Court to make clear the Tax Court's duty to allow the taxpayer every reasonable opportunity to introduce **all** relevant evidence the taxpayer believes necessary to overcome the presumption of correctness given to the Government agency's notice of deficiency or FPAA and to overcome the burden of proof placed on the taxpayers often made even heavier by the Tax Court's frequent disregard of a taxpayers uncontroverted testimony as self-serving. This case deserves reversal because DHRE did not receive a fair trial or due process.

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[18] *E.g. Guenther v. Commissioner*, 939 F.2d 758 (9th Cir. 1991):

> [W]e will not approve the tax court's [sic] move toward a more inquisitorial proceeding... . The violation of the *Guenther*'s due process right entitles them to a new trial in the tax court [sic].

Treaty Pines Investment Partnership v. Commissioner, 967 F.2d 206, 210, 212 (5th Cir. 1992):

> The Tax Court attempted to deprive them of that opportunity by refusing to consider the issue on which depended its jurisdiction to inflict such deprivation... . While we acknowledge that the fisc of the nation should be protected when proper to do so, protection at the expense of a taxpayer's rights is quite 'improper'.

For all of the reasons stated above, this Court should hold that the Tax Court did not have jurisdiction to hear the ITC issue. DHRE asks that this Court to hold that the Tax Court's conduct of the trial denied DHRE a fair trial and due process and to further consider the evidence in the record *de novo* and rule that based upon all of the evidence in the record the trial court's conclusions of law were erroneous and in direct conflict with *Frank Lyon* and that the partnership satisfied the §§ 46(e)(3) and 163(d)(4) interest expense requirements.

Respectfully submitted,

Date: 5/6/96

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APPENDIX TO
PETITION FOR WRIT OF CERTIORARI

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T.C. Memo 1994-143

UNITED STATES TAX COURT

Doctors Hospital Real Estate, Ltd., Doctors Hospital Management Co., Inc., Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent

Docket No. 20343-91. Filed March 31, 1994.

In 1979, a group of doctors organized a corporation, C, to develop and operate a hospital. C's shareholders formed a limited partnership, D, comprised of 43 partners, all but 2 of which were shareholders of C. C leased certain land to D and D agreed to lease to C certain fixed equipment and a hospital building to be constructed on the land. D did not manufacture or produce the equipment subject to the lease to C. Under the lease from D to C, D's maximum contributions for expenses related to the fixed equipment totaled $550,000. Under the lease, the rent C owed D was the amount necessary to maintain and service any indebtedness incurred in connection with the construction of the hospital, and C was also liable for "additional rent" in the amount of $550,000. For one of the taxable years in issue, D paid C the amount of the $550,000 cap on expenses, without determining its actual liability. For another year in issue, D and C did not actually exchange payments.

Held: D does not qualify for the investment credit for 1984. Held, further, certain interest claimed as an ordinary deduction for 1985 and 1986 must be recharacterized as investment interest. Held, further, certain construction-period interest may be currently deducted by D.

Thomas E. Redding and Charles B. Koerth, for petitioner.
Carol Bingham McClure and John Eiman, for respondent.

Memorandum Findings of Fact and Opinion

LARO, Judge: Respondent issued Doctors Hospital Management Co. (petitioner), as tax matters partner of Doctors Hospital Real Estate, Ltd. (DHRE), three notices of final partnership administrative adjustment

(FPAA's). Collectively, the FPAA's covered DHRE's 1984 through 1986 taxable years. In the FPAA for 1984, respondent made an adjustment of $2,253,579 to DHRE's ordinary income, made an adjustment of $1,162,768.55 to DHRE's basis in section 38 property that is subject to the investment tax credit, and made certain adjustments to DHRE's construction-period interest, accelerated depreciation, and net qualified investment income. In the FPAA's for 1985 and 1986, respondent made ordinary income adjustments in the amounts of $1,470,948 and $1,444,580, respectively, and certain adjustments to construction-period interest, accelerated depreciation, investment interest expense, and net qualified investment income. This case is before the Court pursuant to petitioner's petition under section 6226[19] for readjustment of the partnership items set forth in the FPAA.[20] Prior to trial, the Court denied petitioner's three motions to dismiss for lack of jurisdiction.

After concessions by petitioner, the issues for decision are:[21]

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[19] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[20] Respondent issued three notices of final partnership administrative adjustment (FPAA's) on June 3, 1991. The petition was filed on Sept. 9, 1991, and does not bear a United States postmark. The tax matters partner of a partnership has 90 days from the date the FPAA was mailed in which to file a petition. Sec. 6226(a)(1). If the tax matters partner does not file a petition within that 90-day period, any notice partner of the partnership may file a petition within 60 days after the close of the 90-day period. Sec. 6226(b)(1). The tax matters partner of a partnership may also be a notice partner. *Barbados #6 Ltd. v. Commissioner* [Dec. 42,522], 85 T.C. 900 (1985). Although petitioner filed the petition after the close of the 90-day period, it is nonetheless timely because petitioner filed the petition within the following 60 days and petitioner is a notice partner of DHRE. See secs. 6223(a), 6231(a)(8).

[21] Petitioner conceded that: (1) The downward adjustment under sec. 38 reflected in the FPAA's are correct, and that DHRE's claimed cost basis in sec. 38 property must be reduced by $1,162,768.55; (2) certain adjustments to depreciation made in the FPAA's are correct; and (3) certain interest expense claimed as an ordinary deduction for 1984 must be recharacterized as investment interest under sec. 163(d)(4). Petitioner did not assign as an error respondent's adjustments to depreciation of a hospital building. Therefore, petitioner is deemed to have conceded this issue. Rule 34(b)(4); *Merlino v. Commissioner* [Dec. 49,026(M)], T.C. Memo. 1993-200. In addition, petitioner presented no persuasive evidence on this issue, and did not meet its burden of proof. Rule 142(a); *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111, 115 (1933).

(continued...)

(1) Whether DHRE satisfies the noncorporate lessor requirements of section 46(e)(3) and thus qualifies for an investment credit for certain fixed equipment for 1984. We hold it does not.

(2) Whether certain investment interest claimed as an ordinary deduction must be recharacterized as investment interest. We hold it must.

(3) Whether certain construction-period interest must be capitalized or may be currently deducted.[22] We hold it may be currently deducted.

Findings of Fact

Some of the facts have been stipulated and are so found. The stipulations and exhibits attached thereto are incorporated herein by this reference. DHRE's principal place of business at the time it filed the petition was Victoria, Texas (Victoria).

In 1979, a group of doctors began discussing the need for a new hospital in Victoria. The doctors organized Doctors Hospital of Victoria, Inc. (DHV) as a Texas corporation, with the intent of developing and operating a hospital. Stock was issued to 45 physicians practicing medicine in the Victoria area. The doctors then began the process of applying to the State government for a certificate of need for a new hospital. They purchased the Hohf Clinic, with its existing certificate of need for a 50-bed hospital. In June 1981, DHV obtained a certificate of need for a new 106-bed hospital.[23]

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[21] (. . . continued)
The amount of accelerated depreciation that should be treated as a sec. 57(a)(2) tax preference item for each year in issue, a computational adjustment, must also be determined.

Prior to trial, petitioner made a motion for summary judgment regarding DHRE's basis in sec. 38 property, arguing that sec. 46(e) does not constitute a legal basis under which DHRE's basis in sec. 38 property may be adjusted. We took this under advisement, and it will be deemed moot based on petitioner's concession.

[22] Prior to trial, the parties filed cross-motions for summary judgment on this issue. We took these motions under advisement, and our decision on this issue is reflected herein.

[23] The application for a certificate of need reflected that the hospital would be (continued...)

After operating the Hohf Clinic for a little less than a year, the shareholders in DHV realized that they did not have the ability to develop a hospital and needed the assistance of a professional hospital management company. They chose Universal Health Services, Inc. (UHS), a Delaware corporation engaged in the business of operating and owning acute-care hospitals.

In late 1980 or early 1981, DHV obtained an option to purchase 46.889 acres of property; DHV planned to build a hospital on 12 of the acres. The DHV shareholders formed a Texas limited partnership, DHRE, comprised of 43 of the shareholders of DHV plus two other persons. During the years in issue, DHRE used the cash method of accounting and a calendar year taxable year.

In 1982, DHV, DHRE, and UHS carried out a transaction memorialized in a Stock Purchase Agreement. In that transaction, UHS formed a wholly owned Texas subsidiary, Universal Health Services of Victoria, Inc. (Subsidiary). DHV exercised its option to purchase land on which to build the hospital. DHV as lessor and DHRE as lessee entered into a Ground Lease dated January 19, 1982, pursuant to which DHV agreed to lease certain land to DHRE.

On the same day, DHRE and DHV entered into a Hospital Lease, pursuant to which DHRE agreed to lease to DHV a hospital building to be constructed on the land leased by DHV to DHRE pursuant to the Ground Lease.[24] The Hospital Lease granted DHRE the option to lease to DHV any equipment DHV proposed to lease from DHRE. DHRE had no responsibility for any expenses under the Hospital Lease; all expenses were borne by DHV as lessee.

Construction of the hospital was conducted pursuant to a written plan that was in existence on July 1, 1982, and as to which approval from a governmental unit had been requested in writing on May 14, 1981. Construction commenced before January 1, 1984. The hospital was completed in March 1984 and was placed in service on April 1,

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[23] (. . . continued) owned by DHV; the application called for a new 106-bed hospital and the closing of the Hohf Clinic.

[24] After the Ground Lease and Hospital Lease were in place, the shareholders of DHV sold all their stock to Subsidiary.

1984.[25] The total cost was $13,012,403, excluding construction-period interest in the amount of $987,618 and the cost of the equipment.[26]

On March 30, 1984, DHV, DHRE, and Subsidiary entered into an agreement to execute a deed and bill of sale to clarify that DHRE owned the hospital building. DHV agreed to lease the fixed equipment from DHRE, and DHV transferred title to DHRE by a "Bill of Sale".[27] Although the hospital was complete, DHRE had not yet obtained permanent financing; UHS and its subsidiaries had invested over $14 million in construction financing and equipment purchases. DHRE memorialized its debt for construction costs and fixed equipment by giving Subsidiary its note for $14 million while the parties continued to seek mutually agreeable third party financing.

In 1984, UHS realized that the form of the Hospital Lease failed to meet certain standards of the Financial Accounting Standards Board, and initiated renegotiation of the lease. On December 28, 1984, a renegotiated hospital lease was executed (the Revised Lease). Under both the Hospital Lease and the Revised Lease, the rent was "such amount as shall be required to maintain and service any indebtedness incurred in connection with the construction of the Hospital or in connection with any refinancing or refunding of such indebtedness".[28]

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[25] The hospital is a four-story health care facility of approximately 90,637 square feet located on a 12 acre site.

[26] At the time DHRE was formed, the estimated cost of constructing the hospital was approximately $12 million. The equipment leased to the hospital ultimately cost approximately $4 million to $5 million. The cost of the equipment was included in the $12 million estimate.

[27] DHRE did not own any of the movable equipment in the hospital.

[28] Under DHRE's $14 million note of Mar. 30, 1984, DHRE agreed to pay Subsidiary equal monthly installments of $147,451.38 on the first day of each month, commencing on May 1, 1984, and terminating on April 1, 2009. On Dec. 28, 1984, DHRE and Canadian Imperial Bank of Commerce (Canadian) entered into a Term Loan Agreement for a loan in the amount of $10 million. This loan was payable in full on Dec. 28, 1992, but permitted DHRE to make prepayments in increments of $1 million. DHRE signed a note in favor of Canadian in the amount of $10 million. The proceeds of this note were paid to Subsidiary on Dec. 28, 1984, to satisfy $10 million of DHRE's obligation to Subsidiary under DHRE's note dated Mar. 30, 1984. Also on Dec. 28, 1984 DHV canceled the $14 million note and substituted a note for $14,065,000 dated Mar. 30, 1984.

Under the Revised Lease, DHV was liable for "additional rent" in the amount of $550,000.

The lease of the fixed equipment by DHRE to DHV was included in the Revised Lease. DHRE did not manufacture or produce the fixed equipment. Under the Revised Lease, DHRE's maximum contributions for expenses related to the fixed equipment total $550,000, the amount of the additional rent called for in the Revised Lease. Under the Revised Lease, even if DHRE was not liable for the full $550,000, DHV would still be required to pay the full $550,000 additional rent. Dr. William P. Sage, the treasurer of DHRE, never saw an accounting of the amounts it was required to contribute for expenses related to the fixed equipment. John Scott (Scott), an attorney, requested certain information from John Gill (Gill), area financial manager of UHS, annually, but Scott did not ask for an accounting of expenses on a lease-year basis. Gill never made an attempt to compute what the lease-year expense would be.

On December 28, 1984, DHRE received a rent payment of $1,327,062.42.[29] During 1985, DHRE received rent payments totaling $1,838,627.30. From April 1, 1984, through March 31, 1985, DHRE received rent payments totaling $2,120,679.78. During 1986, DHRE received rent payments totaling $1,785,109.94.

On March 28, 1985, DHRE received $550,000 from DHV. Also on March 28, 1985, DHRE wrote four separate checks to DHV, totaling $550,000. DHRE always intended to have the equipment it leased to DHV qualify for the investment credit, and DHRE knew it would have to contribute to the maintenance of that equipment. However, DHRE's only source of cash was rents. Without the $550,000 from DHV, DHRE could not have made the four payments totaling $550,000. For the 1986 taxable year, neither UHS, Subsidiary, nor DHV paid the $550,000 additional rent, and DHRE did not pay any of the amounts under the revised lease that would total $550,000.

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[29] On its 1984 Federal income tax return, DHRE reported net rental income of $1,327,062.42. This amount equals the 9 monthly payments of $147,451.38 due DHV on its $14 million. For 1984, DHRE did not report gross rents or rental expenses.

DHRE worked mainly out of its checkbooks and did not keep a cash receipts and disbursements journal. DHRE deducted no expenses under section 162 on its 1984 Form 1065, U.S. Partnership Return of Income. For 1985, DHRE deducted expenses under section 162 totaling $6,417.28, excluding "rental expenses" of $550,500. For 1986, DHRE deducted expenses under section 162 totaling $12,837, excluding "rental expenses" of $550,581.65 and "rent" of $1,500.

Opinion

The notice of deficiency benefits from a presumption of correctness, and petitioner bears the burden of proving it erroneous. Rule 142(a); *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111, 115 (1933).

Investment Credit

Section 38(a) generally allows taxpayers an investment tax credit. Section 46(e)(3) allows a credit to a business lessor of personal property other than a corporation if (1) the property subject to the lease has been manufactured by the lessor or (2) the term of the lease, including options to renew, is less than 50 percent of the useful life of the property and, for the 12-month period immediately following the transfer of the property to the lessee, the sum of the deductions allowable to the lessor under section 162 (other than rents and reimbursed amounts) exceeds 15 percent of the rental income produced by such property. In enacting section 46(e)(3), Congress intended to deny an investment credit to noncorporate lessors who remain mere passive investors. *Carlson v. Commissioner* [Dec. 39,257], 79 T.C. 215, 221 (1982), affd. [83-2 USTC ¶ 9519] 712 F.2d 1314 (9th Cir. 1983); S. Rept. 92-437, at 44 (1971), 1972-1 C.B. 559, 583; H. Rept. 92-533 at 29, 1972-1 C.B. 498, 513; see also *Sutow v. Commissioner* [Dec. 48,434(M)], T.C. Memo. 1992-473. DHRE, a partnership, is subject to this "noncorporate lessor" limitation. Since DHRE did not manufacture the fixed equipment subject to the lease, DHRE qualifies for the credit only if it satisfies the "useful life" and "expense" tests of section 46(e)(3).

The hospital opened on April 1, 1984; we assume this is the date on which the fixed equipment was transferred to DHV, the lessee. Therefore, the applicable 12-month period runs through March 31, 1985. DHRE did not deduct any expenses under section 162 on its 1984

Federal income tax return, and did not establish its entitlement to any expenses not so deducted. On its 1985 Federal income tax return, DHRE deducted certain expenses under section 162 totaling $6,417.28.[30] Assuming arguendo that DHRE incurred the entire $6,417.28 during the first quarter of 1985, these deductions do not exceed 15 percent of the rental income under the Revised Lease, which totaled $2,120,679.78. Thus, to meet the expense test, DHRE claims that the $550,500 it expended and deducted on its 1985 Federal income tax return was properly deductible under section 162.

The term "reimbursed amounts" is defined as amounts that the lessee or some other person is obligated to reimburse the lessor. Sec. 1.46-4(d)(3)(ii), Income Tax Regs. DHV was obligated to pay DHRE $550,000, in return for DHRE's $550,000 payment. We do not credit petitioner's argument that DHRE's payment to DHV was merely capped at $550,000 and might have been less. On March 28, 1985, DHRE wrote four separate checks to DHV, totaling $550,000, and DHRE received $550,000 from DHV. Without the $550,000 from DHV, DHRE could not have made the four payments totaling $550,000. In the following year, neither party actually made the offsetting "mandatory" payments to each other.[31] We find that, during the applicable 12-month period, DHV reimbursed DHRE for all expenses (other than $6,917.28) that DHRE would have been allowed to deduct under section 162. Cf. Sutow v. Commissioner, supra. Accordingly, because we hold that DHRE fails to meet the "expense test" under section 46(e)(3), we do not reach the issue of whether the term of the lease, including options to renew, is less than 50 percent of the useful life of the property.

Investment Interest

In any taxable year, a taxpayer is generally restricted from deducting investment interest that exceeds the taxpayer's investment income for the taxable year. Sec. 163(d)(1). Section 163(d)(4)(A) deems certain property subject to a lease to be property held for investment; any interest claimed with respect to that property is investment interest. Section 163(d)(4)(A) applies where, during the taxable year, (1) the

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[30] Petitioner did not establish DHRE's entitlement to any deductions under section 162 in excess of those claimed.

[31] Thus, petitioner did not prove that DHV was liable for the $550,000 regardless of whether DHRE made its payments.

sum of the deductions allowable to the lessor under section 162 (other than rents and reimbursed amounts) do not exceed 15 percent of the rental income produced by such property, *or* (2) the lessor is guaranteed a specific return or is guaranteed in whole or in part against loss of income. *Nicholson v. Commissioner* [Dec. 49,007(M)], T.C. Memo. 1993-183, on reconsideration [Dec. 49,283(M)], T.C. Memo. 1993-427.

Petitioner concedes that respondent's determination of 1984 net investment income is correct. In 1985, DHRE deducted $6,417.28 in expenses under section 162, excluding "rental expenses" of $550,500, which were reimbursed amounts to the extent of $550,000. Aside from reimbursed amounts, DHRE's expenses do not exceed 15 percent of the rental income produced by the Hospital Lease for 1985, which totaled $1,838,627.30. In 1986, DHRE deducted $12,837 in expenses under section 162, excluding "rent" of $1,500 and "rental expenses" of $550,581.65 that were reimbursed amounts to the extent of $550,000. DHRE's expenses, other than rent and reimbursed amounts, do not exceed 15 percent of the rental income produced by the Hospital Lease for 1986, which totaled $1,785,109.94. Accordingly, the interest claimed by petitioner for 1985 and 1986 is investment interest within the meaning of section 163(d)(4)(A). Based on this determination, petitioner concedes on brief that the correct amount of net investment income for 1985 and 1986 is as set forth in the FPAA's for those years. Thus, we need not reach the issue of whether DHRE was guaranteed a specific return or is guaranteed in whole or in part against loss of income.

Construction-period interest

In her FPAA's, respondent determined that DHRE's construction-period interest was not currently deductible, but must be capitalized and amortized over a 10-year period. However, respondent allowed petitioner a deduction for construction-period interest deductible by a corporate partner of DHRE. Respondent argues that DHRE must capitalize construction-period interest and amortize it over 10 years. Petitioner argues that DHRE was entitled to a current deduction for such interest.

As enacted by the Tax Reform Act of 1976, Pub. L. 94-445, sec. 201, 90 Stat. 1520, 1525, section 189(a) provided:

> Except as otherwise provided in this section or in section 266 * * *, *in the case of an individual,* no deduction shall be allowed *for real property construction period interest and taxes.* * * *

Sec. 189(a) (emphasis added). The Tax Equity & Fiscal Responsibility Act of 1982, Pub. L. 97-248, sec. 207(a), 96 Stat. 324, 431, amended this section, eliminating the language underscored above; the amendment appears to deny a larger group of persons a deduction for construction-period interest and taxes. As amended by Pub. L. 97-248, 96 Stat. 431, section 189(a) read:

> Except as otherwise provided in this section or in section 266 * * *, no deduction shall be allowed for real property construction period interest and taxes.

This amendment is generally effective with respect to taxable years beginning after December 31, 1982, with respect to construction commencing after such date. However, section 207(e)(2) of Pub. L. 97-248, 96 Stat. 432, provides in part that this amendment does not apply to the construction of a hospital if: (1) The construction is conducted pursuant to a written plan of the taxpayer which was in existence on July 1, 1982, and as to which approval from a governmental unit has been requested in writing, and (2) the construction commences before January 1, 1984. Based on the stipulated facts, petitioner has met these two elements, and is therefore subject to the preamendment rule.

Thus, the version of section 189(a) applicable to the transaction discussed herein prohibits only individuals, not partnerships, from deducting construction-period interest and taxes; DHRE is entitled to deduct such interest, and we rule for petitioner on this issue. Cf. *Aboussie v. United States* [85-2 USTC ¶ 9860], 779 F.2d 424, 427 (8th Cir. 1985).

To reflect the foregoing,

Decision will be entered under Rule 155.

UNITED STATES TAX COURT
WASHINGTON, D. C. 20217

DOCTORS HOSPITAL REAL ESTATE, LTD., DOCTORS HOSPITAL MANAGEMENT CO., INC., TAX MATTERS PARTNER, Petitioner,	§	
v.	§	Docket No. 20343-91
COMMISSIONER OF INTERNAL REVENUE Respondent.	§	

ORDER AND DECISION

Pursuant to a conference call held between the parties and the Court on February 2, 1995, the parties informed the Court that they had made a clerical error in the decision that was entered by the Court on January 12, 1995. For cause, it is

ORDERED that the decision entered by the Court on January 12, 1995, is hereby vacated and set aside. It is further

ORDERED AND DECIDED that the following statement shows the adjustments to the partnership items for Doctors Hospital Real Estate, Ltd. for the taxable years 1984, 1985, and 1986:

	1984	
Partnership Item	As Reported	As Determined
Ordinary Income (Loss)	($2,130,067.00)	($ 864,106.00)
Qualified Investment Property	4,298,835.00	4,005,416.00*

* That Doctors Hospital Real Estate, Ltd. fails to satisfy the noncorporate lessor requirements of I.R.C. sec. 46(e)(3) and thus fails to qualify for the investment tax credit for the taxable year 1984. However, to the extent that a partner is a corporation, it is entitled to an investment tax credit based upon its proportionate share of basis. See flush language of sec. 46(e)(3).

1984

Partnership Item	As Reported	As Determined
Tax Preference Item - Accelerated Depreciation on 15-Year Real Property	-0-	377,710.00
Tax Preference Item - Net Qualified Investment Income	-0-	826,531.00
Investment Interest Expense	-0-	1,257,254.00
Basis in Section 1250 Property Subject to 15-Year ACRS	$8,871,760.41	$9,442,742.15

1985

Partnership Item	As Reported	As Determined
Ordinary Income (Loss)	($1,945,962.00)	($ 475,014.00)
Tax Preference Item - Accelerated Depreciation on 15-Year Real Property	-0-	412,653.00
Tax Preference Item - Net Qualified Investment Income	-0-	611,510.00
Investment Interest Expense	-0-	$1,420,214.00

1986

Partnership Item	As Reported	As Determined
Ordinary Income (Loss)	($1,791,611.00)	($ 347,031.00)
Tax Preference Item - Accelerated Depreciation on 15-Year Real Property	-0-	222,498.00
Tax Preference Item - Net Qualified Investment Income	-0-	549,357.00
Investment Interest Expense	-0-	$1,203,691.00

s/David Laro
David Laro
Judge

Entered: st/FEB 3 1995

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 95-60278

DOCTORS HOSPITAL REAL ESTATE, LTD.,
Doctors Hospital Management Co.,
Tax Matters Partner,
Petitioner - Appellánt,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent - Appellee

Appeal from the United States Tax Court
(20343-91)

Before KING, DAVIS, and BARKSALE, Circuit Judges.

PER CURIAM:*

AFFIRMED. See Local Rule 47.6.

U.S.COURT OF APPEALS
FILED
st/ FEB 08 1996

CHARLES R. FULBRUGE III
CLERK

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* Pursuant to Local Rule 47.5, the court has determined that this opinion should not be published and is not precedent except under the limited circumstances set forth in Local Rule 47.5.4.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

DOCTORS HOSPITAL REAL ESTATE, LTD., DOCTORS HOSPITAL MANAGEMENT CO., INC., TAX MATTERS PARTNER,	§	
Petitioner,	§	
v.	§	Docket No. 95-60278
COMMISSIONER OF INTERNAL REVENUE,	§	
Respondent.	§	

APPELLANT'S MOTION FOR CLARIFICATION AND PUBLICATION

Appellant, Doctors Hospital Real Estate, Ltd. (hereafter "DHRL"), respectfully requests that this Court clarify, and subsequently publish, the basis for its affirmance of the Tax Court's holdings as reflected in its opinion in the above entitled proceeding. This Court's Opinion was issued on February 8, 1996. Specifically, Appellant requests that this Court clarify its holding with regard to the following:

1. Whether this Court's holding was that the $550,000 annual rent was a reimbursement as a matter of law or whether this Court's holding was that the $550,000, as a factual finding, was something other than rent;

2. The basis on which this Court distinguished this case from the controlling precedent established by the United States Supreme Court in *Frank Lyons Co. v. United States*, 435 U.S. 561 (1978);

3. Whether the Court's holding is, as implied by its Opinion, that the definition of "partnership item" includes all facts reasonably determinable at the partnership level whether or not required to be shown on the partnership return, and, if so, the Court's reasoning in distinguishing this case from its own recent published holding in *Sealy Power, Ltd. v. Commissioner*, 46 F.3d 382 (5th Cir. 1995) where it stated that a Notice of Final Partnership Administrative Adjustment is

"the prerequisite for litigation over disputed items **on a partnership's return**." *Id.*, at 385. *Emphasis added;*

4. The rational and basis on which this Court distinguishes the Tax Court's holding in this case from the Tax Court's own established precedent in *Roberts v. Commissioner*, 94 T.C. 853 (1990); and

5. The Court's rationale and basis for distinguishing this case from the clear language of both Internal Revenue Code Secs. 46(a)-(c) and the general instructions to Form 3468, Computation of Investment Credit, as both were written and in effect **for 1984, 1985 and 1986**, the years in issue in this case.[1]

In support of its request, Appellant would respectfully show the Court:

1. Appellant anticipates the filing of a Petition for Writ of Certiorari to the United States Supreme Court and, based on the ambiguous nature of this Court's bare holding that "the Tax Court's opinion is affirmed," is unclear on which bases this Court relies for its affirmance.

2. Clarifying the definition of the term "partnership item" is an extremely important issue in evolving TEFRA partnership procedural law, and the Tax Court's opinion in this case, and this Court's affirmance thereof, is radically divergent from the Tax Court's established precedence in *Roberts, supra.* and this Court's own opinion in *Sealy, supra.*

WHEREFORE, Appellant respectfully requests that this motion be granted.

Respectfully submitted,

Date: s/ 2-23-96

s/ Thomas E. Redding
Thomas E. Redding
REDDING & ASSOCIATES, P.C.
515 Post Oak Blvd., Suite 500
Houston, Texas 77027-9408150
(713) 965-9244
(713) 621-5227 FAX

---

[1] For the specific language in issue, the Court is referred to pp. 20-21 of the Opening Brief for Appellant.

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing Appellant's Motion for Clarification and Publication was served on the Appellee by mailing two copies of same on February 23, 1996 in a postage paid wrapper addressed to Mr. Gary R. Allen, Attorney, Tax Division, Department of Justice, P. O. Box 502, Washington D.C. 20044.

This is to certify that the original of the aforementioned document was transmitted by Federal Express to the Clerk of the Fifth Circuit Court of Appeals on February 23, 1996.

Date: s/ 2-23-96

s/ Thomas E. Redding
Thomas E. Redding

Department of the Treasury
Internal Revenue Service

P-902-722-402 DATE: 06-03-91

REFER TO:

3651 S. INTERREGIONAL HWY
AUSTIN, TX 73301

STOP4161:AUCC
060391-0047

DOCTORS HOSPITAL MANAGEMENT
407 N MOODY
VICTORIA TX 77901

TAXPAYER IDENTIFYING NUMBER:
76-0048551

NAME OF PARTNERSHIP
DOCTORS HOSPITAL REAL ESTATE LTD
TAXPAYER IDENTIFYING NUMBER:
74-2256411
TAX YEAR ENDED:
1984
DATE FPAA MAILED TO
TAX MATTERS PERSON:
06-03-91
PERSON TO CONTACT:
M. PUNDSACK (STOP 4161)
CONTACT TELEPHONE NUMBER:
(512) 326-0257

NOTICE OF FINAL PARTNERSHIP
ADMINISTRATIVE ADJUSTMENT

WE HAVE DETERMINED THAT THERE ARE ADJUSTMENTS TO THE PARTNERSHIP RETURN AS SHOWN ON THE ATTACHED SCHEDULE OF ADJUSTMENTS, FORM 870-P, AGREEMENT TO ASSESSMENT AND COLLECTION OF DEFICIENCY IN TAX FOR PARTNERSHIP ADJUSTMENTS. THIS LETTER IS THE NOTICE OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT (FPAA).

. . . .

. . . .

SCHEDULE OF ADJUSTED ITEMS PAGE 2 OF 4 PAGES

. . . .

REMARKS:

. . . .

3. QUALIFIED INVESTMENT--IRC SECTION 48(Q) UNADJUSTED BASIS

IT IS DETERMINED THAT YOUR UNADJUSTED BASIS IN IRC SECTION 48(Q) QUALIFIED INVESTMENT PROPERTY IS $65,521.00 RATHER THAN $4,298,835.00 AS CLAIMED ON YOUR RETURN FOR THE TAXABLE YEAR ENDED DECEMBER 31, 1984 SINCE:

(A) IT HAS NOT BEEN ESTABLISHED THAT ANY PROPERTY IN EXCESS OF THE AMOUNT SHOWN BELOW MET THE REQUIREMENTS OF SECTION 38 (AS DEFINED BY SECTION 48) OF THE INTERNAL REVENUE CODE; AND

(B) YOU HAVE NOT ESTABLISHED THAT ANY PROPERTY IN EXCESS OF THAT ALLOWED MEETS THE REQUIREMENTS FOR NONCORPORATE LESSORS AS PROVIDED BY SECTION 46 OF THE INTERNAL REVENUE CODE.

SECTION 38 PROPERTY PER EXHIBIT B	$	4,005,416.00
P & S OPTICAL % INTEREST	X	.016358
* SECTION 48(Q) UNADJUSTED BASIS AS CORRECTED	$	65,521.00
SECTION 48(A) UNADJUSTED BASIS CLAIMED PER RETURN		4,298,835.00
DECREASE		4,233,314.00

* PASS THROUGH TO P & S OPTICAL, INC., ONLY.

ACCORDINGLY, YOUR UNADJUSTED BASIS OF SECTION 48(Q) QUALIFIED INVESTMENT PROPERTY, THAT MAY BE PASSED THROUGH TO THE PARTNERS, IS DECREASED IN THE AMOUNT OF $4,233,314.00 FOR THE 1984 TAX YEAR.

Supreme Court, U.S.
FILED
JUL 10 1996
OFFICE OF THE CLERK

No. 95-1835

In the Supreme Court of the United States

OCTOBER TERM, 1995

DOCTORS HOSPITAL REAL ESTATE, LTD., ETC.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

WALTER DELLINGER
Acting Solicitor General
LORETTA C. ARGRETT
Assistant Attorney General
JONATHAN S. COHEN
TAMARA L. SCHOTTENSTEIN
Attorneys
Department of Justice
Washington, D.C. 20530
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QUESTIONS PRESENTED

1. Whether the unified partnership audit proceedings established by 26 U.S.C. 6221 may be applied to determine whether a partnership satisfies the noncorporate lessor requirements of Section 46(e)(3) of the Internal Revenue Code (as in effect during the period of this suit).

2. Whether the Tax Court clearly erred in finding that petitioner was reimbursed for the expenses it contributed, as lessor, toward the operating expenses of a hospital.

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Hayes v. *Commissioner*, 69 T.C.M. (CCH) 2323 (1995)	6, 7
Sealy Power, Ltd. v. *Commissioner*, 46 F.3d 382 (5th Cir. 1995)	6, 7
Tiffany Fine Arts, Inc. v. *United States*, 469 U.S. 310 (1985)	8

Statutes and regulation:

Internal Revenue Code (26 U.S.C.):	
§ 46(e)(3) (1982)	2, 4, 5, 6, 8
§ 46(e)(3)(B) (1982)	2, 3
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In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-1835

DOCTORS HOSPITAL REAL ESTATE, LTD., ETC., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The per curiam order of the court of appeals (Pet. App. 13) is unpublished, but the decision is noted at 79 F.3d 1144 (Table). The opinion of the Tax Court (Pet. App. 1-10) is reported at 67 T.C.M. (CCH) 2591 (1994).

JURISDICTION

The judgment of the court of appeals was entered on February 6, 1996. The petition for a writ of certiorari was filed on May 6, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Doctors Hospital Real Estate, Ltd. is a limited partnership. It is therefore subject to the provisions of Sections 6221 through 6233 of the Internal Revenue Code that require the tax treatment of items of partnership income, loss, deductions and credits to be determined in a single proceeding at the partnership level. 26 U.S.C. 6221-6233. The scope of the unified partnership audit procedures—and of judicial review of adjustments made in those audits—is limited to "partnership items." 26 U.S.C. 6221, 6226(f). This case concerns whether the issue of whether petitioner satisfied the noncorporate lessor requirements of Section 46(e)(3) of the Internal Revenue Code—so that its individual partners could claim an investment tax credit—relates to a "partnership item" to which the unified audit provisions apply.[1]

Under Section 46(e)(3)(B) of the Code as then in effect, a noncorporate lessor of property could qualify for the investment tax credit available for certain types of leased property only if two preconditions were met: (i) the term of the lease must have been less than 50 percent of the useful life of the property and (ii) for the period consisting of the first 12 months after the property was transferred to the lessee, the sum of the deductions with respect to the property that were allowable to the lessor under Section 162 of the Code (other than rents and reimbursed amounts)

---

[1] Petitioner also claimed in the Tax Court that that court did not have jurisdiction to consider whether petitioner's interest expense for 1984, 1985, and 1986 was investment interest. The Tax Court rejected petitioner's claim, and the court of appeals affirmed. Petitioner does not seek further review of that aspect of the courts' decisions.

must have exceeded 15 percent of the rental income that the lessor received from the property. 26 U.S.C. 46(e)(3)(B) (1982). See Pub. L. No. 94-12, §302(a), 89 Stat. 40 (1975). These two requirements have been referred to, respectively, as the "useful life test" and the "expense test" (Pet. App. 7). They are designed to insure that the lessor is actively engaged in the conduct of the business and is not a passive investor (*ibid.*).

1. In 1979, a group of doctors organized a corporation named Doctors Hospital of Victoria in order to develop and operate a new hospital (Pet. App. 3). After the corporation acquired property as a location for the new hospital, the doctors and others formed petitioner as a limited partnership to develop the property (*id.* at 4). In early 1982, the corporation leased the land to the partnership. The partnership then leased the land and the hospital that was to be built on the property back to the corporation (*ibid.*). Under the hospital lease, the corporation was responsible for all expenses incurred in operating the hospital (*ibid.*). The rent paid by the corporation for use of the hospital was set at the amount the partnership required to service the indebtedness it incurred in constructing the hospital (*id.* at 5).

The doctors decided that they did not have the expertise or financial ability to run a hospital. After the leases between the partnership and the corporation were in place, the doctors sold their stock in the corporation to Universal Health Services, Inc., which was engaged in the business of owning and operating acute-care hospitals (Pet. App. 4). The hospital was thereafter constructed and placed in service in April 1984 (*id.* at 4-5).

At the end of 1984, the parties revised the hospital lease (Pet. App. 5). The revised lease included a lease of fixed equipment and required the partnership to contribute to the operating expenses of the hospital the sum of $550,000 per year (*id.* at 6). The corporation remained responsible under the lease for paying to the partnership the amount required to service the indebtedness incurred in constructing the hospital (*id.* at 5). In addition, the revised lease required the corporation to pay the partnership "additional rent" in the amount of $550,000 per year—the same amount that the partnership was required to contribute to the operating expenses of the hospital (*id.* at 6).

2. On its 1984 federal information tax return, the partnership claimed that it owned property with a basis of $4.3 million that qualified for an investment tax credit to be passed through to each of its individual partners (Pet. App. 11, 18). The Internal Revenue Service issued notices of final partnership administrative adjustment to the partnership for its 1984, 1985, and 1986 taxable years (*id.* at 2). The notice for 1984 indicated that petitioner did not satisfy the statutory prerequisites for investment tax credits applicable to noncorporate lessors under Section 46(e)(3) (Pet. App. 18).

3. Petitioner sought a redetermination of the partnership adjustments in the Tax Court. Prior to trial, petitioner moved to dismiss portions of the case, contending that the Tax Court lacked jurisdiction to determine whether petitioner satisfied the noncorporate lessor requirements of Section 46(e)(3). Petitioner argued that this requirement was not a "partnership item" over which the Tax Court had jurisdiction in a unified partnership proceeding.

The Tax Court denied the motion to dismiss and, after a trial on the merits, upheld the Commissioner's determinations. The court concluded that petitioner, as a noncorporate lessor of the hospital equipment, could qualify for the investment tax credit with respect to that equipment only if it satisfied the "useful life test" and the "expense test" under Section 46(e)(3) of the Code. The court explained (Pet. App. 7-8) that petitioner could not meet the "expense test" because the $550,000 that it contributed towards the operating expenses of the hospital was reimbursed by the corporation and therefore was a "reimbursed amount" within the meaning of the statute. Because the court found that petitioner did not satisfy the "expense test," it did not decide whether petitioner met the "useful life test" (*id.* at 8). The court of appeals affirmed without opinion (*id.* at 13).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. As in effect during the years relevant to this suit, Section 46(e)(3) of the Code limited the investment tax credit in cases involving noncorporate lessors of property. The tests imposed by that statute must be met before any investment tax credit resulting from petitioner's operations may be allowed. And, as the courts below correctly concluded, application of those statutuory tests to petitioner requires the determination of a "partnership item" over which the Tax Court had jurisdiction under 26 U.S.C. 6221, 6226(e).

The statute defines the term "partnership items" to mean "any item required to be taken into account for the partnership's taxable year * * * to the extent regulations prescribed by the Secretary provide that * * * such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). The regulations issued by the Secretary under this statute provide that "partnership items" include "[i]tems of * * * credit of the partnership" as well as "[o]ther amounts determinable at the partnership level with respect to partnership * * * transactions and operations necessary to enable the partnership or the partners to determine the investment tax credit" (26 C.F.R. 301.6231(a)(3)-1(a)). The regulation thus specifically requires that application of the requirements of Section 46(e)(3) to petitioner is to be determined "at the partnership level" in order "to determine the investment tax credit" for all partners in a unified proceeding.

Petitioner does not claim that the straightforward application of this regulation by the courts below conflicts with any decision of this Court or any other court of appeals. Instead, petitioner claims only (Pet. 5, 11) that the reasoning of the Tax Court's opinion conflicts with decisions of the Fifth Circuit and of the Tax Court in *Sealy Power, Ltd.* v. *Commissioner*, 46 F.3d 382 (5th Cir. 1995); *Alexander* v. *United States*, 44 F.3d 328 (5th Cir. 1995); *Hambrose Leasing* v. *Commissioner*, 99 T.C. 298 (1992); *Hayes* v. *Commissioner*, 69 T.C.M. (CCH) 2323 (1995); and *Gemini Twin Fund III* v. *Commissioner*, 62 T.C.M. (CCH) 104 (1991), aff'd, 8 F.3d 26 (9th Cir. 1993) (Table). Petitioner's allegation of an intra-circuit conflict and of a conflict within the Tax Court itself would not,

even if true, warrant review by this Court. But the suggestion that these decisions are in conflict is erroneous in any event, for it does not take into account the distinct factual contexts of these cases. In particular, none of the cases on which petitioner relies involves the question presented here—whether a unified proceeding should be employed "to determine * * * [t]he investment credit" resulting from a partnership's activities, as the regulation expressly requires (26 C.F.R. 301.6231(a)(3)-1(a)).[2]

Whether an issue is more appropriately determined at the partnership level or at the partner level depends upon whether it is a matter that must be determined with reference to the partnership and would affect the partners uniformly or, instead, is a matter that may be resolved differently for different partners, based upon their individual circumstances. The decision in this case is in complete harmony with that principle.

---

[2] *Sealy Power* did not involve the definition of partnership items. Instead, it addressed the validity of a notice of partnership adjustment that the taxpayer claimed was arbitrary and capricious. 46 F.3d at 385. *Alexander* was concerned with the point in time at which a partnership item becomes a non-partnership item. 44 F.3d at 331. In *Hambrose*, the court held that the determination of a partner's amount "at risk" with respect to partnership liabilities was not a partnership item because it turned on circumstances and arrangements unique to each individual partner. 99 T.C. at 310. *Hayes* was not concerned with the definition of partnership item, but was merely a partner-level proceeding following *Hambrose*. 69 T.C.M. (CCH) at 2326. And the court in *Gemini Twin Fund III* merely noted that Tax Court decisions, such as *Hambrose*, had held that the determination of a partner's amount at risk was not a partnership item. 62 T.C.M. (CCH) at 107.

2. The Tax Court found that petitioner was fully reimbursed for the $550,000 that it ostensibly contributed to the operating expenses of the hospital and that petitioner therefore did not satisfy the "expense test" of Section 46(e)(3). That finding was sustained by the court of appeals. Further review of that factual determination, concurred in by the two courts below, is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

Petitioner errs in contending (Pet. 15-18) that the court's finding on this factual issue conflicts with this Court's decision in *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). In *Frank Lyon*, the Court held that an arrangement under which a bank sold a building to the taxpayer and simultaneously leased it back from the taxpayer had real econcomic substance and should be recognized for tax purposes. *Id.* at 582-583. That decision has nothing to do with this case. The Tax Court in this case did not conclude that the existence of the various leases and leasebacks should be disregarded. Instead, the court concluded that the terms of those very leases resulted in such substantial reimbursement of costs to petitioner that petitioner did not satisfy the "expense test" of Section 46(e)(3). Nothing in *Frank Lyon* would require any different conclusion in this case.[3]

---

[3] Petitioner's further contention (Pet. 18-25) that it was deprived of a fair trial because it "had no reason to prepare for trial on the noncorporate lessor issues" (Pet. 20) is frivolous. The notice of partnership adjustments issued to petitioner stated that "you [petitioner] have not established that any property in excess of that allowed meets the requirements for noncorporate lessors as provided by Section 46 of the Internal

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General
LORETTA C. ARGRETT
Assistant Attorney General
JONATHAN S. COHEN
TAMARA L. SCHOTTENSTEIN
Attorneys

JULY 1996

Revenue Code" (Pet. App. 18). The noncorporate lessor issue was thus directly and properly before the Tax Court.

Petitioner also plainly errs in contending (Pet. 21-25) that the Tax Court abused its discretion in refusing to admit certain proffered evidence. As the Tax Court explained, the evidence that was not admitted was either already before the court or was irrelevant to the case (see *ibid.*). In any event, the evidentiary complaints now raised by petitioner were not addressed by the court of appeals, do not present any conflict among the circuits and do not warrant review by this Court.